



# China-U.S. Trade Issues

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## Summary

U.S.-China economic ties have expanded substantially over the past three decades. Total U.S.-China trade has risen from \$5 billion in 1980 to \$409 billion in 2008. In 2008, China was the second largest U.S. trading partner, its third largest export market, and its biggest source of U.S. imports. About 12% of total U.S. global trade is now with China. According to U.S. data, U.S. firms have invested around \$28 billion in China (through 2007), some of which is aimed at the Chinese domestic market, while other investment has gone into export-oriented manufacturing facilities.

With a huge population and a rapidly expanding economy, China is a potentially huge market for U.S. exporters. However, bilateral economic relations have become strained over a number of issues, including large and growing U.S. trade deficits with China (\$266 billion in 2008), China's failure to fully implement its World Trade Organization (WTO) commitments (especially in regards to protection of intellectual property rights), its refusal to adopt a floating currency system, its use of industrial policies (such as subsidies) and other practices deemed unfair and/or harmful to various U.S. economic sectors, and its failure in some cases to ensure that its exported products meet U.S. health and safety standards.

Further complicating the bilateral economic relationship is China's large holdings of U.S. debt, such as Treasury securities. In September 2008, China overtook Japan to become the largest foreign holder of such securities. Some analysts welcome China's purchases of U.S. debt securities, which help fund U.S. budget deficits, while others have expressed concerns that growing Chinese holdings of U.S. debt may increase its leverage over the United States.

The current global economic crisis could further challenge China-U.S. economic ties. Many analysts have expressed concern that the Chinese government may, in an effort to help its sagging export industries, implement new trade barriers, boost industrial subsidies, and/or depreciate its currency, which could harm some U.S. firms and workers. Many U.S. policymakers have urged China to lessen its reliance on exports for its economic growth and instead implement policies to promote domestic consumption. Central to this position is the belief that China should appreciate its currency and eventually adopt a floating exchange rate system, which would boost its imports.

Several Members of Congress have urged the Obama Administration to take a more assertive approach in dealing with Chinese economic practices, including increasing the use of U.S. antidumping, countervailing, and safeguard provisions, bringing more dispute resolution cases against China in the WTO, and continuing pressure on China to appreciate its currency. Others have warned against using "protectionist" measures to block imports of Chinese goods and have advocated using high-level bilateral talks (such as the Strategic Economic Dialogue that began during the Bush Administration in 2006) to resolve major trade disputes.

This report examines major U.S.-China trade issues and related legislation, and will be updated as events warrant.

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Economic and trade reforms begun in 1979 have helped transform China into one of the world's fastest growing economies. China's economic growth and trade liberalization, including comprehensive trade commitments made upon entering the World Trade Organization (WTO) in 2001, have led to a sharp expansion in U.S.-China economic ties. Yet, bilateral trade relations have grown increasingly strained in recent years over a number of issues, including a large and growing U.S. trade deficit with China, China's refusal to adopt a floating currency, failure to fully implement many of its WTO obligations, especially in regards to protection of intellectual property rights (IPR), and problems relating to the health and safety of Chinese-made products. Several Members of Congress have called on the Administration to take a tougher stance against China to induce it to eliminate economic policies deemed harmful to U.S. economic interests and/or are inconsistent with WTO rules.

This report provides an overview of U.S.-China economic relations, surveys major trade disputes, and lists bills introduced in the 111<sup>th</sup> Congress that would impact bilateral commercial ties.

## U.S. Trade with China<sup>1</sup>

U.S.-China trade rose rapidly after the two nations re-established diplomatic relations (in January 1979), signed a bilateral trade agreement (July 1979), and provided mutual most-favored-nation (MFN) treatment beginning in 1980.<sup>2</sup> In 1978 (before China's reforms began), total U.S.-China trade (exports plus imports) was \$1 billion; China ranked as the 32<sup>nd</sup> largest export market and the 57<sup>th</sup> largest source of U.S. imports. In 2008, bilateral trade hit \$409 billion, making China the second largest U.S. trading partner (after Canada), the third largest U.S. export market, and the largest source of U.S. imports. In recent years, China has been one of the fastest growing U.S. export markets and the importance of this market is expected to grow even further as living standards continue to improve and a sizable Chinese middle class emerges.

The U.S. trade deficit with China has surged in recent years as imports from China have grown much faster than U.S. exports to China (although it grew by only \$10 billion in 2008). That deficit rose from \$34 billion in 1995 to \$266 billion in 2008 (see **Table 1**); it was significantly larger than that with any other U.S. trading partner and several trading groups. For example, it was nearly equal to the combined U.S. deficits with the countries that make up the Organization of the Petroleum Export Countries (OPEC) and the 27 countries that make up the European Union (EU27), and it was more than three times larger than the trade deficit with Japan (see **Table 2**). Many Members of Congress view the huge U.S. trade deficit with China as an indicator that China's economic and trade policies are restrictive or unfair.<sup>3</sup>

<sup>1</sup> For more information on China's economy, see CRS Report RL33534, *China's Economic Conditions*, by Wayne M. Morrison. For general information on U.S.-China ties, see CRS Report RL33877, *China-U.S. Relations: Current Issues and Implications for U.S. Policy*, by Kerry Dumbaugh.

<sup>2</sup> The United States suspended China's MFN status in 1951, which cut off most bilateral trade. China's MFN status was conditionally restored in 1980 under the provisions set forth under Title IV of the 1974 Trade Act, as amended (including the Jackson-Vanik freedom of emigration provisions), and that status was renewed on an annual basis through January 2002.

<sup>3</sup> The United States ran trade deficits with 91 countries in 2008. These totaled \$951.9 billion; the trade deficit with China was equal to 27.9% of this amount. However, the United States ran trade surpluses with several countries, totaling \$151.9 billion, and the total U.S. trade deficit was \$800.0 billion. On this basis, the U.S. trade deficit with China was equal to 33.3% of the total U.S. trade deficit. However, most economists contend that bilateral trade are poor (continued...)

**Table 1. U.S. Merchandise Trade with China: 1980-2008**

(\$ in billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0.0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1
2003	28.4	152.4	-124.0
2004	34.7	196.7	-162.0
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3
2008	71.5	337.8	-266.3

Source: USITC DataWeb.

**Table 2. U.S. Merchandise Trade Balances with Major Trading Partners: 2008**

(\$ in billions)

Country or Trading Group	U.S. Trade Balance
World	-800.0
<b>China</b>	<b>-266.3</b>
Organization of Petroleum Exporting Countries (OPEC)	-175.6
European Union (EU27)	-93.4
Canada	-74.6
Japan	-72.7
Mexico	-64.4
Association of Southeast Asian Nations (ASEAN)	-50.6

Source: USITC DataWeb.

(...continued)

indicators of a nation's trade policies since nations will run trade deficits with some countries and surpluses with other, based on a number of economic factors.

## Major U.S. Exports to China

U.S. merchandise exports to China in 2008 were \$71.5 billion, up 9.5% (compared to an 18.1% rise in 2007) over the previous year.<sup>4</sup> In 2007, China overtook Japan to become the third largest U.S. export market and was third in 2008. U.S. exports to China in 2008 accounted for 5.5% of total U.S. exports (compared to 3.9% in 2003). The top five U.S. exports to China in 2008 were waste and scrap, semiconductors and electronic components, oilseeds and grain, aircraft and parts, and resins and synthetic rubber and fibers (see **Table 3**). China is a significant market for U.S. agricultural products. It was the fourth largest destination for U.S. agricultural exports in 2008 at \$12.1 billion, up 46.5% over the previous year. Major U.S. agricultural exports to China include soybeans, meat products, and cotton.<sup>5</sup>

Over the past few years, China has been one of the fastest growing U.S. export markets, as can be seen in **Table 4**. U.S. exports to China rose by nearly 240% from 2001 to 2008, which was higher than that of any other of the top 10 U.S. trading partners.

**Table 3. Major U.S. Exports to China: 2008**

(\$ in millions and percent change)

	2004	2005	2006	2007	2008	Percent Change 2007 - 2008
NAIC Number and Description	\$ millions					
9100 Waste and scrap	2,508	3,670	6,071	7,331	7,562	3.1%
3344 Semiconductors and other electronic components	3,565	4,015	6,830	7,435	7,475	0.5%
1111 Oilseeds and grains	2,829	2,339	2,593	4,145	7,316	76.5%
3364 Aerospace products and parts	2,111	4,535	6,309	7,447	5,471	-26.5%
3252 Resin, synthetic rubber, and artificial & synthetic fibers & filament	1,631	2,127	2,548	3,290	3,524	7.1%

**Source:** USITC DataWeb

**Notes:** North American Industry Classification system, 4-digit level.

<sup>4</sup> The United States also exports a significant level of private services to China; these totaled \$14.2 billion in 2007.

<sup>5</sup> Some U.S. analysts have expressed concern over the composition of U.S. exports to China, noting that much of it consists of scrap products, components, and food, as opposed to high-value assembled manufactured products (such as cars). Chinese officials complain that U.S. export controls on high tech trade has a significant negative impact on the composition and size of U.S. exports to China.



**Table 4. U.S. Merchandise Exports to Major Trading Partners in 2001 and 2008**  
(\$ in billions and % change)

	2001	2008	% Change from 2007-2008	% Change from 2001-2008
Canada	163.7	260.9	5.0	59.4
Mexico	101.5	151.5	11.0	49.3
<b>China</b>	<b>19.2</b>	<b>71.5</b>	<b>9.5</b>	<b>272.3</b>
Japan	57.6	66.6	6.2	15.6
Germany	30.1	54.7	10.2	31.9
United Kingdom	40.8	53.8	6.9	31.9
Netherlands	19.5	40.2	21.9	106.2
South Korea	22.2	34.8	6.9	56.8
Brazil	15.9	32.9	33.6	106.9
France	19.9	29.2	6.5	46.7
World	731.0	1,300.1	11.8	77.9

**Source:** USITC DataWeb. Ranked by top 10 U.S. export markets in 2008.

Many trade analysts argue that China could prove to be a much more significant market for U.S. exports in the future. China is one of the world's fastest-growing economies, and rapid economic growth is likely to continue in the near future, provided that economic reforms are continued. China's goal of modernizing its infrastructure and upgrading its industries is predicted to generate substantial demand for foreign goods and services. Finally, economic growth has substantially improved the purchasing power of Chinese citizens, especially those living in urban areas along the east coast of China. China's growing economy and large population make it a potentially enormous market. To illustrate:

- China currently has the world's largest mobile phone network and one of the fastest-growing markets, with an estimated 592 million mobile phone users (as of May 2008), compared to 87 million users in 2000.
- Boeing Corporation predicts that China will be the largest market for commercial air travel outside the U.S. for the next 20 years (2008-2027); during this period, China will buy 3,710 aircraft valued at \$390 billion.<sup>6</sup> On April 11, 2006, Boeing announced it had signed a general purchase agreement with China for 80 Boeing 737s. On September 6, 2007, China announced it would buy 55 Boeing aircraft valued at \$3.8 billion.
- It is estimated that China in 2008 replaced the United States as the world's largest Internet user: 253 million users versus 221 million respectively (as of June 2008).<sup>7</sup> Yet, the percentage of the Chinese population using the Internet is small relative to the United States: 19% versus 73%, respectively.

<sup>6</sup> Boeing, Current Market Outlook, 2008-2027,

<sup>7</sup> New York Times, "China Surpasses U.S. in Number of Internet Users," July 26, 2008.

- The Chinese government projects that by the year 2020, there will be 140 million cars in China (seven times the current level), and that the number of cars sold annually will rise from 7.2 million units (2006) to 20.7 million units in 2020.<sup>8</sup> According to some estimates, China is now the world's second largest market for new cars. General Motors (GM) and Ford reportedly sold 1.09 million and 306 thousand vehicles, respectively, in China in 2008.<sup>9</sup> The *International Herald Tribune* reported in 2007 that GM expected to invest \$5 billion in China over the next five years to expand production facilities.<sup>10</sup>

## Major U.S. Imports from China

China was the largest source of U.S. imports in 2008 at \$338 billion, or 16.1% of total U.S. imports (up from 6.5% of total in 1996).<sup>11</sup> U.S. imports from China rose by 5.1% in 2008 over the previous year (compared with an 11.7% rise in 2007). The importance (ranking) of China as a source of U.S. imports has risen dramatically, from eighth largest in 1990, to fourth in 2000, to second in 2004-2006, to first in 2007-2008. The top five U.S. imports from China in 2008 were computers and parts, miscellaneous manufactured articles (such as toys, games, etc.), communications equipment, apparel, and audio and video equipment (see **Table 5**). The growth in U.S. imports from China slowed in 2008 over growth in 2007: 5.7% versus 11.7%, respectively.

**Table 5. Major U.S. Imports From China: 2008**

(\$ in millions and percent change)

NAIC Number and Description	2004	2005	2006	2007	2008	Percent Change 2007 - 2008
	\$ in millions					
3341 computer equipment	29,486	35,467	40,046	44,462	45,820	3.1%
3399 Miscellaneous manufactured commodities	23,712	26,449	28,888	34,827	35,835	2.9%
3342 Communications equipment	9,015	14,121	17,977	23,192	26,618	14.8%
3152 Apparel	10,530	16,362	19,228	22,955	22,583	-1.6%
3343 Audio and video equipment	12,421	15,287	18,789	19,075	19,715	3.4%

**Source:** USITC DataWeb

**Notes:** North American Industry Classification system, 4-digit level.

<sup>8</sup> *China Daily*, September 9, 2004.

<sup>9</sup> According to GM's website, it operates seven joint ventures and two wholly owned foreign enterprises and has more than 20,000 employees in China.

<sup>10</sup> *International Herald Tribune*, "GM plans \$5 billion in China investment," December 6, 2007. For additional information on China's auto industry, see CRS Report RL33317, *China's Impact on the U.S. Automotive Industry*, by Stephen Cooney.

<sup>11</sup> U.S. imports from China as a share of total imports in 2007 was 16.5%.

Throughout the 1980s and 1990s, nearly all of U.S. imports from China were low-value, labor-intensive products such as toys and games, consumer electronic products, footwear, and textiles and apparel. However, over the past few years, an increasing proportion of U.S. imports from China has comprised of more technologically advanced products, such as computers. According to the U.S. Census Bureau, in 2008, U.S. imports of advanced technology products from China totaled \$91.4 billion (27.1% of total U.S. imports from China), compared with \$29.3 billion in 2003 (19.2% of total U.S. imports from China).<sup>12</sup> In addition, imports of advanced technology products from China accounted for 27.5% of total U.S. imports of such products in 2008, compared with 14.1% in 2003, indicating that U.S. dependency on China for advanced technology products is rapidly increasing.<sup>13</sup>

Many analysts contend that the sharp increase in U.S. imports from China (and hence the growing trade deficit) is largely the result of movement in production facilities from other (primarily) Asian countries to China.<sup>14</sup> That is, various products that used to be made in Japan, Taiwan, Hong Kong, etc., and then exported to the United States are now being made in China (in many cases, by foreign firms in China) and exported to the United States. An illustration of this shift can be seen in **Table 6**, which lists U.S. imports of computer equipment and parts from 2000-2008. For example, in 2000, Japan was the largest foreign supplier of U.S. computer equipment (with a 19.6% share of total shipments), while China ranked fourth (with a 12.1% share). In just eight years, Japan's ranking fell to fourth, the value of its shipments dropped by over half, and its share of U.S. computer imports declined to 7.7% (2008). China was by far the largest foreign supplier of computer equipment in 2008 with a 53.6% share of total U.S. imports. While U.S. imports of computer equipment from China rose by 452% over the past eight years, the total value of U.S. computer imports from the world rose by only 25%. Many analysts contend that a large share of the increase in Chinese computer production has come from foreign computer companies that have moved manufacturing facilities China.

**Table 6. Major Foreign Suppliers of U.S. Computer Equipment Imports: 2000-2008**  
(\$ in billions and % change)

	2000	2002	2004	2006	2008	2000-2008 % change
Total	68.5	62.3	73.9	83.8	85.4	24.7
<b>China</b>	<b>8.3</b>	<b>12.0</b>	<b>29.5</b>	<b>40.0</b>	<b>45.8</b>	<b>451.8</b>
Malaysia	4.9	7.1	8.7	11.1	9.0	83.7
Japan	13.4	8.1	6.3	6.3	6.6	-50.7
Mexico	6.9	7.9	7.4	6.6	6.2	-10.1
Singapore	8.7	7.1	6.6	5.6	4.0	-54.0

**Source:** U.S. International Trade Commission Trade Data Web.

**Note:** Ranked according to top five suppliers in 2008.

<sup>12</sup> U.S. Census Bureau, Foreign Trade Division.

<sup>13</sup> U.S. exports of advanced technology to China in 2008 were \$18.7 billion; these accounted for 26.2% of total U.S. exports to China and 6.8% of total U.S. advanced technology exports.

<sup>14</sup> Chinese data indicate that the share of China's exports produced by foreign-invested enterprises (FIEs) in China rose from 1.9% in 1986 to 55% in 2008.

China has become a major source of U.S. agricultural imports. It was the third largest supplier of such imports in 2008 (compared with 12<sup>th</sup> largest in 2000), at \$4.7 billion. U.S. agricultural imports from China rose by 42.2% in 2008 and by 104.5% from 2004-2008. Major agricultural imports from China include seafood products, vegetables and fruit, and animal foods.

## Investment Ties

Investment plays a major role in U.S.-China commercial ties.<sup>15</sup> China's investments in U.S. assets can be broken down into two categories: holdings of U.S. securities and foreign direct investment (FDI). The Treasury Department defines foreign holdings of U.S. securities as "U.S. securities owned by foreign residents (including banks and other institutions) except where the owner has a direct investment relationship with the U.S. issuer of the securities." These include long-term (LT) U.S. Treasury securities, LT U.S. government agency securities,<sup>16</sup> LT corporate securities (some of which are asset-backed), equities (such as stocks), and short-term debt.<sup>17</sup> The U.S. Bureau of Economic Analysis (BEA) defines FDI (in the United States) as "the ownership or control, directly or indirectly, by one foreign resident of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or the equivalent interest in an unincorporated U.S. business enterprise."<sup>18</sup> BEA classifies FDI flows according to broad industrial sections, including mining; utilities; manufacturing (broken down into nine subsectors<sup>19</sup>); wholesale trade; information; depository institutions; finance (excluding depository institutions); professional, scientific, and technical services; nonbank holding companies; and other industries.

## China's Holdings of U.S. Securities<sup>20</sup>

The Treasury Department performs annual surveys of foreign holders of U.S. securities, the latest of which was released in February 2009 (preliminary data) for holding as of June 2008.<sup>21</sup> China's total holdings of U.S. securities at the end of June 2008 were estimated at \$1,205 billion, up from \$922 billion in June 2007. From June 2002 to June 2008, China's holdings of U.S. securities as a share of total foreign holdings of U.S. securities rose from 3.9% to 11.7% and its ranking increased from fifth to second (after Japan at \$1,250 billion). China could become the largest

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<sup>15</sup> U.S. data on FDI flows to and from China differ sharply from Chinese data on FDI flows to and from the United States. This section uses U.S. data.

<sup>16</sup> Agency securities include both federal agencies and government-sponsored enterprises created by Congress (e.g., Fannie Mae and Freddie Mac) to provide credit to key sectors of the economy. Some of these securities are backed by assets (such as home mortgages).

<sup>17</sup> LT securities are those with no stated maturity date (such as equities) or with an original term to maturity date of more than one year. Short-term debt includes U.S. Treasury securities, agency securities, and corporate securities with a maturity date of less than one year.

<sup>18</sup> The 10% ownership share is the threshold considered to represent an effective voice or lasting influence in the management of an enterprise. See, BEA, *International Economic Accounts, BEA Series Definitions*, available at <http://www.bea.gov/international>.

<sup>19</sup> These sectors include food; chemicals; primary and fabricated metals; machinery; computers and electronic products; electrical equipment, appliances and components; transportation equipment, and other manufacturing.

<sup>20</sup> For additional information on this issue, see CRS Report RL34314, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, by Wayne M. Morrison and Marc Labonte

<sup>21</sup> U.S. Treasury Department, *Preliminary Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2008*, February 27, 2009. A final report expected in April 2009.

holder in 2009 see **Table 7**). From June 2002 to June 2008, China's U.S. securities holdings grew by nearly \$1.1 trillion (or 566%), which was by far the largest increase in U.S. securities holdings of any other country.<sup>22</sup> These holdings are largely the result of China's currency policy (discussed below). The largest type of U.S. securities held by China are U.S. Treasury securities, which are used to finance U.S. budget deficits; data for foreign holdings of these type of securities are reported on a monthly basis. China's holdings of U.S. Treasury securities rose from \$118 billion (or 9.6% of total foreign holdings) at the end of 2002 to \$727.4 billion (23.6% of foreign holdings) in December 2008. China's holdings as of January 2009 were \$739.6 billion or 24.1% of total foreign holdings (see **Table 8**).<sup>23</sup> In September 2008, China overtook Japan to become the largest foreign holder of U.S. Treasuries.

**Table 7. China's Holdings of U.S. Securities: June 2002-June 2008**  
(\$ billions and percent change)

2002	2003	2004	2005	2006	2007	2008	2002-2008 % change
188	255	341	527	699	922	1,205	566%

**Source:** U.S. Department of Treasury.

**Notes:** U.S. securities include short term and long-term debt, including Treasury securities, U.S. government agency securities, corporate securities, and equities.

**Table 8. China's Holdings of U.S. Treasury Securities: 2002-2008 Year-End and January 2009**  
(\$ billions and as a percent of total foreign holdings)

	2002	2003	2004	2005	2006	2007	2008	Jan 2009
China's Holdings (\$billions)	118.4	159.0	222.9	310.0	396.9	477.6	727.4	739.6
Holdings As a Percent of Total Foreign Holdings	9.6%	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	24.1

**Source:** U.S. Treasury Department.

**Notes:** Data based on periodical surveys by the Treasury Department, which often revises estimates for the previous year but not for all years and thus should be interpreted with caution.

Many U.S. policymakers have raised concern over China's large and growing holdings of U.S. securities, stating that while such purchases have helped the United States meet its investment needs and have helped fund the growing U.S. Federal budget deficit, they could give China increased leverage over the United States on major political and economic issues. On the other

<sup>22</sup> U.S. Treasury Department, *Report on Foreign Portfolio Holdings of U.S. Securities*, various editions. Note, 2002 was the first year in which surveys listed data as of June. Prior to that, survey data were listed as of March or December.

<sup>23</sup> U.S. Treasury Department, *Major Foreign Holders of U.S. Treasury Securities*, February 27, 2009. Note, the Treasury Department often revises its estimates of foreign holdings for a given year, but not for previous years.

hand, Chinese officials have expressed concern over the “safety” of their large holdings of U.S. debt. Many analysts contend that China’s economy is so dependent on a healthy and stable U.S. economy that it has no choice but to keep buying U.S. government debt. However, Chinese officials are worried that growing U.S. government debt will spark inflation in the United States and a sharp depreciation of the dollar, which would diminish the value of China’s dollar assets.<sup>24</sup>

## U.S. Holdings of Chinese Securities

The Treasury Department also does surveys on U.S. holdings of Chinese securities reports; these are on a year-end basis. The last survey (issued in October 2008) estimated total U.S. holdings of Chinese securities at \$97.2 billion in 2007 (98% of which were in equities), up from \$13.7 billion in 2003. U.S. holdings of Chinese securities in 2007 were equal to about 1.3% of total U.S. holdings of foreign securities.<sup>25</sup>

## Bilateral FDI Flows

China’s FDI in the United States is quite small relative to its holdings of U.S. securities: \$1.1 billion (cumulative at the end of 2007) versus \$922 billion (as of June 2007), respectively.<sup>26</sup> In 2007, China ranked as the 30<sup>th</sup> largest source for FDI in the United States.<sup>27</sup> On the other hand, total U.S. FDI in China in 2007 was \$28.3 billion (nearly 26 times China’s FDI in the United States), making China the 21<sup>st</sup> largest U.S. destination for FDI (see **Table 9**).<sup>28</sup>

**Table 9. China’s Cumulative FDI in the United States and U.S. FDI in China: 2002-2007**

(\$ in millions and percent change)

	2002	2003	2004	2005	2006	2007	2002-2007 percent change (%)
China’s FDI in the U.S.	385	284	435	574	974	1,091	183.4
U.S. FDI in China	10,570	11,261	17,616	19,016	23,405	28,298	167.7

**Source:** U.S. Bureau of Economic Analysis.

**Notes:** Data on a historical-cost basis.

<sup>24</sup> See China View, “U.S. stimulus-related debt could hurt investors, China warns,” February 18, 2009.

<sup>25</sup> U.S. Treasury Department, *Report on U.S. Portfolio Holdings of Foreign Securities as of December 31, 2007*, October 2008.

<sup>26</sup> All BEA data is on a historical-cost, or book value, basis.

<sup>27</sup> In comparison, total U.S. FDI in China in 2007 was \$28.3 billion—nearly 26 times China’s FDI in the United States—making China the 21<sup>st</sup> largest U.S. destination for FDI.

<sup>28</sup> Chinese FDI data differ significantly from U.S. data. China estimates that cumulative U.S. FDI in China through 2007 was \$56.6 billion (7.4% of total FDI in China) and that its FDI in the United States was \$1.9 billion (equal to 1.6% of total Chinese FDI).

## Major U.S.-China Trade Issues

Although China's economic reforms and rapid economic growth have expanded U.S.-China commercial relations in recent years, tensions have arisen over a wide variety of issues, including the growth and size of the U.S. trade deficit with China (which many Members contend is an indicator that the trade relationship is unfair), concerns over unsafe Chinese food and consumer products, China's currency policy (which many Members blame for the size of the U.S. trade deficit with China and the loss of U.S. manufacturing jobs), China's mixed record on implementing its obligations in the WTO, including its failure to provide adequate protection of U.S. intellectual property rights (IPR), and Chinese industrial policies used to promote and protect domestic industries. Legislation has been introduced to respond to several of these issues (see section on legislation).

### Health and Safety Concerns Over Certain Imports from China<sup>29</sup>

Reports throughout 2007 of tainted or unsafe food and consumer products (including seafood, pet food, toys, and tires) from China raised concerns in the United States over the health, safety, and quality of imports from China. Some analysts contend that China maintains a poor regulatory framework for enforcing its health and safety regulations and standards, and that this is proving to be a growing problem for U.S. consumers. Many U.S. policymakers have raised concern over how to press China to improve enforcement of its health and safety standards of its exports as well as the ability of U.S. regulatory agencies to ensure the health and safety of imports from China (and other countries).

In 2007 and 2008, there were numerous recalls, warnings, and safety concerns involving Chinese products, as the following instances illustrate.

**The Food and Drug Administration (FDA)** in March 2007 issued warnings and announced voluntary recalls on over 150 brands of pet foods (and products such as rice protein concentrate and wheat gluten used to manufacture pet food and animal feed) from China believed to have caused the sickness and deaths of numerous pets in the United States.<sup>30</sup> In May 2007, the FDA issued warnings on certain toothpaste products (some of which were found to be counterfeit) found to originate in China that contained poisonous chemicals. In June 2007, the FDA announced import controls on all farm-raised catfish, basa, shrimp, dace (related to carp), and eel from China after antimicrobial agents, which are not approved in the United States for use in farm-raised aquatic animals, were found. The FDA ordered that such shipments will be detained until they are proven to be free of contaminants.<sup>31</sup> On January 25, 2008, the FDA posted on its website a notice by Baxter Healthcare Corporation that it had temporarily halted the manufacture of its multiple-dose vials of heparin (a blood thinner) for injection because of recent reports of

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<sup>29</sup> For additional information on this issue, see CRS Report RS22713, *Health and Safety Concerns Over U.S. Imports of Chinese Products: An Overview*, by Wayne M. Morrison.

<sup>30</sup> For a legal overview of FDA recalls, see CRS Report RL34167, *The FDA's Authority to Recall Products*, by Vanessa K. Burrows.

<sup>31</sup> In addition, FDA has refused shipments of a variety of Chinese food and drug products. See CRS Report RL34080, *Food and Agricultural Imports from China*, by Geoffrey S. Becker.

serious adverse events associated with the use of the drug, including 246 deaths from January 2007 to May 2008. Some analysts have speculated that an unlicensed drug company in China, which produces ingredients for the drug, may be the source of the problem.<sup>32</sup> On September 12, 2008, the FDA issued a health information advisory on infant formula in response to reports of contaminated milk-based infant formula manufactured and sold in China, and later issued a warning on other products containing milk imported from China. On November 12, 2008, the FDA issued a new alert stating that all products containing milk imported from China would be detained unless proven to be free of melamine. On December 2, 2008, the Chinese government reported that melamine-tainted formula had so far killed six children and sickened 294,000 others (51,900 of whom had to be hospitalized and 154 were in serious condition).<sup>33</sup>

**The National Highway Traffic Safety Administration (NHTSA)** in June 2007 was informed by Foreign Tire Sales, Inc., an importer of foreign tires, that it suspected that up to 450,000 tires (later reduced to 255,000 tires) made in China may have a major safety defect (i.e., missing or insufficient gum strip inside the tire). The company was ordered by the NHTSA to issue a recall. The Chinese government and the manufacturer have maintained that the tires in question meet or exceed U.S. standards.

**The Consumer Product Safety Commission (CPSC)** has issued alerts and announced voluntary recalls by U.S. companies on numerous products made in China. From January-December 2007, over four-fifths of CPSC recall notices involved Chinese products. Over this period, roughly 17.6 million toys were recalled because of excessive lead levels. Recalls were also issued on 9.5 million Chinese-made toys (because of the danger of loose magnets), 4.2 million “Aqua Dots” toys (because of beads that contained a chemical that can turn toxic if ingested) and 1 million toy ovens (due to potential finger entrapment and burn hazards).<sup>34</sup> China is the dominant supplier of toys to the United States, accounting for 89% of total U.S. imports (2007). U.S. recalls of lead-tainted Chinese-made toys were sharply down in 2008, totaling about 2.5 million toy units.<sup>35</sup>

## China’s Poor Regulatory System and Implications

China is believed to have a rather weak health and safety regime for manufactured goods and agricultural products. Problems include:

- weak consumer protection laws and poorly enforced regulations,
- lack of inspections and ineffective penalties for code violators,
- underfunded and understaffed regulatory agencies and poor interagency cooperation,

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<sup>32</sup> *New York Times*, “China Didn’t Check Drug Supplier, Files Show,” February 16, 2008.

<sup>33</sup> On October 15, 2008, the Chinese government issued an urgent notice to recall all dairy products made prior to September 14, 2008, so that they could be tested.

<sup>34</sup> For a list of company recalls of Chinese products, see the CPSC website at <http://www.cpsc.gov/cpscpub/prerel/prerel.html>. In addition, several U.S. retailers have announced that they have halted sales of certain Chinese products, due to health and safety concerns, which do not appear on the CPSC website.

<sup>35</sup> Congressional concerns over product safety led to the enactment of the *Consumer Product Safety Improvement Act of 2008* (P.L. 110-314) in August 2008. The law tightened requirements on children products, including mandatory testing. See CRS Report RL34684, *Consumer Product Safety Improvement Act of 2008: P.L. 110-314*, by Margaret Mikyung Lee.



- the proliferation of fake goods,
- the existence of numerous unlicensed producers,
- falsified export documents,
- extensive pollution,<sup>36</sup>
- intense competition that often induces firms to cut corners,
- the relative absence of consumer protection advocacy groups,
- failure by Chinese companies to effectively monitor the quality of their suppliers' products,
- restrictions on the media,<sup>37</sup> and
- widespread government corruption and lack of accountability, especially at the local government level.

Although China has criticized the United States for its actions against unsafe Chinese products,<sup>38</sup> it has pledged to improve and strengthen food and drug safety supervision and standards, beef up inspections, require safety certificates before some products can be sold, and crack down on government corruption.

The United States and China reached a number of agreements in 2007 to address health and safety concerns:

- On September 11, 2007, the CPSC and its Chinese counterpart, the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), signed a Joint Statement on enhancing consumer product safety. China pledged to implement a comprehensive plan to intensify efforts (such as increased inspections, efforts to educate Chinese manufacturers, bilateral technical personal exchanges and training, regular meetings to exchange information with U.S. officials, and the development of a product tracking system) to prevent exports of unsafe products to the United States, especially in regard to lead paint in toys.
- On September 12, 2007, the NHTSA signed a Memorandum of Cooperation with its Chinese counterpart on enhanced cooperation and communication on vehicles and automotive equipment safety.
- On December 11, 2007, the U.S. Department of Health and Human Services (HHS) announced that it had signed two Memoranda of Agreements (MOA) with its Chinese counterparts; the first covering specific food and feed items that have been of concern to the United States, and the second covering drugs and medical

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<sup>36</sup> For example, many fish farmers in China are believed to feed various drugs to the fish to help keep them alive in polluted waters. See *Washington Post*, "Farmed in China's Foul Waters, Imported Fish Treated with Drugs; Traditional Medicine, Banned Chemicals Both Used," July 6, 2007, p. A1.

<sup>37</sup> China's media often reports on health and safety problems, but rarely criticizes the central government for such problems.

<sup>38</sup> In June 2007, China impounded U.S. shipments of apricots and orange pulp, claiming that they contained excessive bacteria. In July 2007, China had suspended some frozen chicken and pork products imported from the U.S., citing various health concerns. In August 2007, China rejected a shipment of U.S. pacemakers, due to quality concerns. Some analysts contend these have been retaliatory moves over U.S. recalls and detentions of Chinese products.

devices. Both MOAs would require Chinese firms that export such products to the United States to register with the Chinese government and to obtain certification before they can export. Such firms would also be subject to annual inspections to ensure they meet U.S. standards. The MOAs also establish mechanisms for greater information sharing, increase access of production facilities by U.S. officials, and create working groups in order to boost cooperation. In March 2008, the FDA announced that it would post eight FDA inspectors in China.

## China's Currency Policy<sup>39</sup>

Unlike most advanced economies, China does not maintain a market-based floating exchange rate. Between 1994 and July 2005, China pegged its currency, the renminbi (RMB) or yuan, to the U.S. dollar at about 8.28 yuan to the dollar. In July 2005, China appreciated the RMB to the dollar by 2.1% and moved to a “managed float,” based on a basket of major foreign currencies, including the U.S. dollar. In order to maintain a target rate of exchange with the dollar (and other currencies), the Chinese government has maintained restrictions and controls over capital transactions and has made large-scale purchases of U.S. dollars (and dollar assets). According to the Bank of China, from July 21, 2005, to March 31, 2009, the dollar-yuan exchange rate went from 8.11 to 6.84, an appreciation of 18.6%.<sup>40</sup>

Many U.S. policymakers and business representatives have charged that China's currency policy has made the RMB significantly undervalued vis-à-vis the U.S. dollar (with estimates ranging from 15% to 40%) and that this makes Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. They complain that this policy has particularly hurt several U.S. manufacturing sectors (such as textiles and apparel, furniture, plastics, machine tools, and steel), which are forced to compete against low-cost imports from China, and further contend that it has been a major factor in the size and growth of the U.S. trade deficit with China. Numerous bills have been introduced over the past few years to pressure China to either significantly appreciate its currency or to let it float freely in international markets.

Chinese officials have argued that its currency policy is not meant to favor exports over imports, but instead to foster domestic economic stability. They have expressed concern that abandoning its currency policy could cause an economic crisis in China and would especially hurt its export industries sectors at a time when painful economic reforms (such as closing down inefficient state-owned enterprises and restructuring the banking system) are being implemented. Chinese officials view economic stability as critical to sustaining political stability; they fear an appreciated currency could reduce jobs and lower wages in several sectors and thus cause worker unrest.

Section 3004 of the 1988 Omnibus Trade and Competitiveness Act (P.L. 100-418) requires the Secretary of Treasury to issue a report every six months on international economic policy (including exchange rate policy) and to determine if any country is manipulating its currency in

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<sup>39</sup> For additional information on this issue, see CRS Report RS21625, *China's Currency: A Summary of the Economic Issues*, by Wayne M. Morrison and Marc Labonte; and CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

<sup>40</sup> Source: Calculated from Bank of China data using the official middle rate.

order to prevent an effective balance of payments adjustment or to gain an unfair competitive advantage in international trade. After China reformed its currency in July 2005, the Bush Administration continued to press China to further reform its currency and its financial sector, but declined to cite China for currency manipulation. Many Members of Congress have expressed hope that the Obama Administration will cite China as a currency manipulator in order to pressure it to appreciate and reform its currency.

Further complicating the issue of China's currency policy is its large holdings of U.S. debt (such as Treasury securities). The Chinese government has had to make large-scale purchases of U.S. dollars to meet its exchange rate targets. Rather than hold dollars (which earn no interest), China has sought to invest its dollars in U.S. assets, primarily U.S. government debt securities. On the one hand, some analysts welcome China's purchases of U.S. debt securities, especially during the current financial crisis in the United States where efforts to stimulate the economy will likely require the government to issue large amounts of new debt. They warn that threatening China over its currency policy could induce the Chinese government to slow its purchases, or even sell off current holdings, of U.S. Treasury Securities, which could contribute to higher U.S. interest rates. On the other hand, other policymakers have expressed concern that growing Chinese holdings of U.S. debt may increase its leverage over the United States on a number of economic and non-economic issues, and some contend that China's currency policy was a contributing factor to the current global economic crisis.<sup>41</sup>

## China and the World Trade Organization

Negotiations for China's accession to the General Agreement on Tariffs and Trade (GATT) and its successor organization, the WTO, began in 1986 and took over 15 years to complete. During the WTO negotiations, Chinese officials insisted that China was a developing country and should be allowed to enter under fairly lenient terms. The United States insisted that China could enter the WTO only if it substantially liberalized its trade regime. In the end, a compromise was reached that requires China to make immediate and extensive reductions in various trade and investment barriers, while allowing it to maintain some level of protection (or a transitional period of protection) for certain sensitive sectors. China's WTO membership was formally approved at the WTO Ministerial Conference in Doha, Qatar on November 10, 2001. Taiwan's WTO membership was approved the next day. On November 11, 2001, China notified the WTO that it had formally ratified the WTO agreements, and on December 11, 2001, it formally joined the WTO. Under the WTO accession agreement, China agreed to:

- Reduce the average tariff for industrial goods and agriculture products to 8.9% and 15%, respectively (with most cuts made by 2004 and all cuts completed by 2010).
- Limit subsidies for agricultural production to 8.5% of the value of farm output and eliminate export subsidies on agricultural exports.
- Within three years of accession, grant full trade and distribution rights to foreign enterprises (with some exceptions, such as for certain agricultural products, minerals, and fuels).

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<sup>41</sup> For additional information on this issue, see CRS Report RL34314, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, by Wayne M. Morrison and Marc Labonte; and CRS Report RS22984, *China and the Global Financial Crisis: Implications for the United States*, by Wayne M. Morrison.

- Provide non-discriminatory treatment to all WTO members. Foreign firms in China will be treated no less favorably than Chinese firms for trade purposes. End discriminatory trade policies against foreign invested firms in China, such as domestic content rules and technology transfer requirements.
- Implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement upon accession. (That agreement establishes basic standards on IPR protection and rules for enforcement.)
- Accept a 12-year safeguard mechanism in cases where a surge in Chinese exports cause or threaten to cause market disruption to U.S. (or other WTO members) domestic producers, which allow temporary restrictions on those products. China also agreed that the United States (and other WTO members) could continue to apply a non-market economy methodology for measuring dumping in antidumping investigations of imports from China for 15 years.
- Fully open the banking system to foreign financial institutions within five years (by the end of 2006). Joint ventures in insurance and telecommunication will be permitted (with various degrees of foreign ownership allowed).

## WTO Implementation Issues

China has made great strides in implementing key aspects of its WTO commitments. For example, its average overall tariff has dropped from 15.6% in 2001 to 9.9% in 2009 (the tariff rate on industrial goods and agricultural products is 8.9 and 15.2, respectively) and a number of non-tariff measures have been eliminated. However, there have been several areas where China's implementation is considered to be incomplete. The USTR's seventh annual China WTO compliance report (issued in December 2008) identified several areas of concern, including failure by the Chinese government to maintain an effective IPR enforcement regime (discussed below), industrial policies and national standards that attempt to promote Chinese firms (while discriminating against foreign firms), restrictions on trading and distribution rights (especially in regards to IPR products, such as movies, books, and music), discriminatory and unpredictable health and safety rules on imports (especially agricultural products), burdensome regulations and restrictions on services (including excessive capital requirements), and failure to provide adequate transparency of trade laws and regulations.<sup>42</sup>

The USTR's December 2008 China WTO report stated that China's failure to comply with key areas of its WTO commitments largely stemmed from its incomplete transition to a market based economy. A significant part of the economy, including the banking system and state owned enterprises (SOEs), are controlled by the central government—remnants of the old command economy that existed before reforms began in 1979. Although China agreed to make SOEs operate according to free market principles when it joined the WTO, U.S. officials contend that SOEs are still being subsidized, especially through the banking system. In addition, China is attempting to promote the development of several industries (such as autos, steel, telecommunications, and high technology products) deemed by the government as important to China's future economic development and has implemented policies to promote and protect them.

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<sup>42</sup> USTR, *2008 Report to Congress on China's WTO Compliance*, December 23, 2008.

When China joined the WTO, it agreed to provide a full description of all its subsidy programs, but to date has failed to fully do so. In addition, China agreed to make its state-owned enterprises operate according to market principles; yet such firms continue to receive direction and subsidies. Some major issues of concern to the United States include the following:

- In December 2006, the Chinese government designated seven industries (military equipment, power generation and distribution, oil, telecommunications, coal, civil aviation, and shipping) as critical to the nation's economic security and stated it must retain "absolute control" and limit foreign participation.<sup>43</sup>
- On June 30, 2006, China announced a partial opening of its beef market, which had been completely closed to U.S. imports in 2003, due to concerns over mad cow disease. However, U.S. officials have expressed disappointment that China has failed to develop a science-based trading protocol for importing beef from the United States, which would enable the United States to resume beef trade with China.
- In July 2005, the Chinese government issued new guidelines on steel production, which reportedly include provisions for the preferential use of domestically produced steel-manufacturing equipment and domestic technologies; extensive government involvement in determining the number, size, location, and production quantities of steel producers in China; technology transfer requirements on foreign investment; and restrictions on foreign majority ownership. On June 14, 2006, Assistant U.S. Trade Representative for China Tim Stratford stated that China's steel guidelines were "troubling, because it attempts to dictate industry outcomes and involves the government in making decisions that should be left to the marketplace."<sup>44</sup> The U.S. steel industry has expressed growing fears that Chinese government policies have led to overinvestment and overcapacity in China's domestic steel industry, which could lead it to flood world markets with cheap steel.<sup>45</sup> Such concerns led the USTR to begin a Steel Dialogue with China (which first met in March 2006) to discuss issues of concern to the U.S. steel industry.
- China's Automotive Industrial Policy, issued by the government in May 2004, includes provisions discouraging the importation of auto parts and encouraging the use of domestic technology, while requiring new automobile and automobile engine plants to include substantial investment in research and development facilities. New auto parts regulations that went into effect in April 2005 discriminate against imported auto parts by assessing an additional charge on imported parts if they are incorporated into a vehicle that does not meet minimum levels of domestic content, discussed below.<sup>46</sup>

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<sup>43</sup> *China Daily*, "Nation Lists Sectors Critical to National Economy," December 19, 2006.

<sup>44</sup> Statement of Timothy Stratford, Assistant U.S. Trade Representative for China Affairs, before the Congressional Steel Caucus, June 14, 2006.

<sup>45</sup> China is now the world's largest steel producer, accounting for 31% of the world's steel production. Its steel production levels rose by 25% over the previous year. According to U.S. officials, China's excess steel capacity in 2006 could be larger than total U.S. steel production.

<sup>46</sup> China applies higher tariffs on imported auto parts when a specific combination of parts is used to produce cars in China, or if the value of these parts amounts to 60% or more of the cost of a car made in China. This policy increases tariffs on some auto parts from about 10% to about 25% (which is the tariff China currently applies to imports of (continued...))

To date, the United States has initiated seven WTO dispute resolution cases against China, four of which have been resolved. China has filed one case against the United States. These cases are summarized below.

### **Pending Cases**

- On April 10, 2007, the USTR filed two IPR-related cases against China: the first case charges that China has failed to comply with the TRIPS agreement (namely in terms of its enforcement of IPR laws) and the second case charges that China has failed to provide sufficient market access to IPR-related products, namely in terms of trading rights and distribution services. On January 26, 2009, the WTO ruled that many of China's IPR enforcement policies failed to WTO obligations (see IPR section, below).
- On December 19, 2008, the USTR filed a WTO case against China over its support for "Famous Chinese" brand programs, charging that such programs utilize various export subsidies (including cash grant rewards, preferential loans, research and development funding to develop new products, and payments to lower the cost of export credit insurance) at the central and local government level to promote the recognition and sale of Chinese brand products overseas.
- On September 19, 2008, China initiated its first WTO case against the United States in regards to its use of antidumping and countervailing measures against certain Chinese products.

### **Resolved Cases**

- On March 30, 2006, the USTR initiated a WTO case against China for its use of discriminatory regulations applied to imported auto parts (which often applies the high tariff rate on finished autos to certain auto parts), stating that the purpose of these rules was to discourage domestic producers from using imported parts and encouraging foreign firms to move production to China. On February 13, 2008, a WTO panel ruled that China's discriminatory tariff policy was inconsistent with its WTO obligations (stating that the auto tariffs constituted an internal charge rather than ordinary customs duties, which violated WTO rules on national treatment). China appealed the decision, but a WTO Appellate Body largely upheld the WTO panels decision.
- On March 3, 2008, the USTR requested WTO dispute resolution consultations with China regarding its discriminatory treatment of U.S. suppliers of financial information services in China. On November 13, 2008, the USTR announced that China had agreed to eliminate discriminatory restrictions on how U.S. and other foreign suppliers of financial information services do business in China.
- On February 5, 2007, the USTR announced it had requested WTO dispute consultations with China over government regulations that give illegal (WTO-inconsistent) import and export subsidies to various industries in China (such as

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(...continued)

completed autos). Source: USTR 2007 *Report to Congress on China's WTO Compliance*, p. 61.

steel, wood, and paper) that distort trade and discriminate against imports.<sup>47</sup> China's WTO accession agreement required it to immediately eliminate such subsidies. On November 29, 2007, China formally agreed to eliminate the subsidies in question by January 1, 2008.

- On March 18, 2004, the USTR announced it had filed a WTO dispute resolution case against China over its discriminatory tax treatment of imported semiconductors. The United States claimed that China applied a 17% VAT rate on semiconductor chips that were designed and made outside China, but gave VAT rebates to domestic producers. Following consultations with the Chinese government, the USTR announced on July 8, 2004, that China agreed to end its preferential tax policy by April 2005. However, the USTR has expressed concern over new forms of financial assistance given by the Chinese government to its domestic semiconductor industry.

## **Violations of U.S. Intellectual Property Rights**

### **History of U.S. Efforts to Improve China's IPR Regime**

The United States has pressed China to improve its IPR protection regime since the late 1980s. In 1991, the United States (under a Section 301 case) threatened to impose \$1.5 billion in trade sanctions against China if it failed to strengthen its IPR laws. Although China later implemented a number of new IPR laws, it often failed to enforce them, which led the United States to once again threaten China with trade sanctions. The two sides reached a trade agreement in 1995, which pledged China to take immediate steps to stem IPR piracy by cracking down on large-scale producers and distributors of pirated materials and prohibiting the export of pirated products, establishing mechanisms to ensure long-term enforcement of IPR laws and providing greater market access to U.S. IPR-related products.

Under the terms of China's WTO accession (see above), China agreed to immediately bring its IPR laws in compliance with the TRIPS agreement. The U.S. Trade Representative's (USTR) office has stated on a number of occasions that China has made great strides in improving its IPR protection regime, noting that it has passed several new IPR-related laws, closed or fined several assembly operations for illegal production lines, seized millions of illegal audio-visual products, curtailed exports of pirated products, expanded training of judges and law enforcement officials on IPR protection, and expanded legitimate licensing of film and music production in China. However, the USTR has indicated that much work needs to be done to improve China's IPR protection regime.

IPR protection has become one of the most important bilateral trade issues between the United States and China in recent years, as the following examples illustrate.

- During the April 2004 U.S.-China Joint Commission on Commerce and Trade (established in 1983) meeting, the Chinese government pledged to "significantly reduce" IPR infringement levels by increasing efforts to halt production, imports,

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<sup>47</sup> Some programs give tax preferences, tariff exemptions, discounted loans, or other benefits to firms that meet certain export performance requirements, while others give tax breaks for purchasing Chinese-made equipment and accessories over imports.

and sales of counterfeit goods and lowering the threshold for criminal prosecution of IPR violations.

- On November 19, 2004, eight members of the House Ways and Means Committee sent a letter to the Chinese Ambassador to the United States expressing concern that proposed Chinese regulations on government procurement of software would virtually lock out U.S. software companies due to requirements for local content and technology transfer.
- On December 16, 2004, General Motors Daewoo Auto & Technology Company (a division of General Motors) filed a case in China against Chery Automobile Co. Ltd. (a Chinese firm) for allegedly violating its IPR by copying one of its car models (the Chevrolet Spark) to produce the Chery QQ. The two companies reportedly settled the issue in November 2005.<sup>48</sup>
- On February 9, 2005, the International Intellectual Property Alliance and the U.S. Chamber of Commerce urged the USTR to initiate WTO consultations with China over its poor record on IPR enforcement.
- On April 29, 2005, the USTR announced that it had placed China on the Special 301 “Priority Watch List,” due to “serious concerns” over China’s compliance with its WTO IPR obligations and China’s failure to fully implement its pledges on IPR made in April 2004 to make a significant reduction in IPR piracy. The USTR urged China to launch more criminal piracy cases and to improve market access for IPR-related products and warned that it was considering taking a case to the WTO if IPR enforcement did not soon show significant improvement.
- During the July 2005 U.S.-China Joint Commission on Commerce and Trade (JCCT)<sup>49</sup> meeting, China agreed to boost enforcement of IPR, such as increasing criminal prosecutions of IPR offenders, improving cooperation among Chinese enforcement officials and between U.S. and Chinese IPR officials, and taking special steps to halt movie and internet piracy. It also pledged to improve government coordination of enforcement efforts and to ensure the use by all levels of the Chinese government (including state-owned firms) of legitimate software products. In addition, the Chinese government agreed to delay implementing proposed regulations restricting government purchases of foreign-made software.
- On October 26, 2005, the United States initiated a special process under WTO rules to obtain detailed information on China’s IPR enforcement efforts. However, on December 22, 2005, China responded by challenging the legal basis for such a request in the WTO and subsequently refused to provide the data.
- During the JCCT meeting on April 11, 2006, China pledged to improve IPR protection by requiring that computers manufactured in China contain legitimate software. On April 19, 2006, Chinese president Hu asserted that licensed

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<sup>48</sup> *Asia Wall Street Journal*, November 21, 2005.

<sup>49</sup> The JCCT was established in 1983 to serve as a forum for high-level dialogue on bilateral trade issues. In 1994, it was enhanced by the establishment of specific working groups, which have grown to include trade and investment issues, business development and industrial cooperation, commercial law, textiles, IPR, trade remedies, statistics, travel and tourism, high-tech and strategic trade, and agricultural trade.



computer software was being introduced in all levels of government and that in 2006 this would be extended to include large state enterprises.

- On April 28, 2006, the USTR listed China as a Priority Foreign Country in its Special 301 report, and stated that, based on China's limited progress in improving its IPR enforcement regime, the USTR was close to filing a WTO dispute case against China. In addition, the USTR indicated that next year's Special 301 report would include a survey of China's IPR protection practices at the provincial level.<sup>50</sup> The 2006 report identified Guangdong Province, Beijing City, Zhejiang Province, and Fujian Province as "hot spots" that required additional attention and resources for IPR enforcement. The report stated that, despite some improvements, China had failed to meet its April 2004 commitments to substantially reduce the level of IPR piracy.
- On December 12, 2007, the Motion Pictures Association of America, Inc. issued a press release stating that "China may have instituted a block on the import of American films into their country."<sup>51</sup> Although Chinese officials said no such ban was in effect, several U.S. industry officials claimed that such restrictions were in place and speculated they were in retaliation over the U.S. WTO cases against China involving IPR issues.<sup>52</sup>
- The USTR's 2008 Special 301 Report (issued on April 25, 2008) stated that its top IPR protection and enforcement priorities were China and Russia. The report stated that Chinese counterfeit products, such as pharmaceuticals, electronics, batteries, auto parts, industrial equipment, and toys "pose a direct threat to the health and safety of consumers in the United States, China and elsewhere."

## The Scope of the IPR Piracy Problem in China

U.S. firms contend that IPR piracy in China has worsened in recent years, despite Chinese government promises to strengthen IPR enforcement by increasing criminal prosecutions of IPR offenders (and toughening penalties), improve coordination among IPR enforcement officials, and make a long term concentrated effort to stamp out major piracy centers.<sup>53</sup> Many business groups contend that poor IPR protection is one of the most significant obstacles for doing business in China. To illustrate:

- The International Intellectual Property Rights Alliance (IIPA) estimates that piracy of business software and records and music in China cost U.S. firms \$3.5 billion in 2008 (the same level as 2007) —the highest among any of the 48 countries and territories surveyed.<sup>54</sup>

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<sup>50</sup> This appears to be motivated by the belief that since IPR enforcement is particularly bad at the local level, the designation or description of specific provinces might prompt officials there to boost their enforcement efforts.

<sup>51</sup> Press release available at <http://www.mpaa.org/PressReleases.asp>.

<sup>52</sup> *New York Times*, "China Said to Block U.S. Films," December 11, 2007.

<sup>53</sup> Often the Chinese government will announce a major campaign to crack down on piracy, conducting widespread raids, shutting down illegal factories, and destroying pirated products. However, once the campaign period is over, enforcement becomes lax, and the illegal activity resurfaces. As a result, the long term result of the government's anti-piracy campaign appears to be negligible in terms of piracy rates.

<sup>54</sup> IIPA attempts to measure industry losses due to piracy in motion pictures, records and music, business software, entertainment software, and books. See IIPA website at <http://www.iipa.com>.

- According to the U.S. Customs and Border Protection (CBP), China accounted for 81% (\$221 million domestic value) of pirated goods seized by the agency in FY2008.<sup>55</sup>
- According to a representative of the Motion Picture Association of America, “China is the most difficult market to crack for the U.S. motion picture industry,” nine out of ten movie DVDs are fake, and 2005 losses from piracy in China were an estimated \$244 million.<sup>56</sup> Major causes of the high piracy levels in China are attributed to be the Chinese government’s tight restrictions on the number of foreign movies allowed to be imported (20 per year), extensive periods of government review and censure requirements before a foreign movie can be legitimately shown, tight limits on distribution of films by foreign companies, and government pressure on movie houses to show only Chinese-made movies.
- American music producers have faced similar problems in terms of high piracy rates in China (estimated by IIPA at 90% in 2007), trade and investment barriers on legitimate products, and large-scale exports of pirated music CDs by illegal Chinese firms. Piracy of music and recordings is estimated to have cost U.S. firms \$451 million in 2007.<sup>57</sup> Pirated music, music videos, and movies are also widely distributed over the Internet in China.<sup>58</sup>
- The Chinese government estimates that counterfeits constitute between 15% and 20% of all products made in China and are equivalent to about 8% of China’s annual gross domestic product.
- A study by the Motion Picture Association of America estimated that China’s domestic film industry lost about \$1.5 billion in revenue to piracy in 2005 (and that the combined losses of both foreign and Chinese film makers totaled \$2.7 billion).<sup>59</sup> It also found that about half of pirated films in China are Chinese movies.
- The Chinese government estimates that 500 million pirated books are produced in China each year.<sup>60</sup>

Opinions differ as to why the Chinese government has been unable make a significant reduction in the level of piracy in China. Some explanations put forward by various analysts include the following:

- China’s transformation from a Soviet-style command economy (in which the government owned and controlled nearly every aspect of the economic life) to one that is becoming more market-based is a very recent occurrence. IPR is a relatively alien or unfamiliar concept for most people in China to grasp (as is the

<sup>55</sup> See CBP website at <http://www.CBP.gov>.

<sup>56</sup> Statement by Dan Glickman, Chairman and Chief Executive Officer, Motion Picture Association of America before the House Ways & Means Committee, Subcommittee on Trade, hearing on Trade With China, February 15, 2007.

<sup>57</sup> The International Federation of the Phonographic Industry (IFPI) estimates that more than 350 million illegal discs were sold in China in 2005.

<sup>58</sup> IPR piracy has become so prevalent in China that it has produced a number of humorous quips, such as “if you did not see a fake DVD, you were not in China,” and (in Shanghai) “we can copy everything except your mother.”

<sup>59</sup> *Reuters*, “China Piracy Costs Film Industry \$2.7 Billion in 2005,” June 19, 2006.

<sup>60</sup> *Xinhua News Agency*, March 19, 2007.

concept of private property rights) and thus it is difficult for the government to convince the public that piracy is wrong.<sup>61</sup>

- Chinese leaders want to make China a major producer of capital-intensive and high-technology products and thus they are tolerant of IPR piracy if it helps Chinese firms become more technologically advanced.<sup>62</sup>
- Although the central government may be fully committed to protection of IPR, local government officials are often less enthusiastic to do so because production of pirated products generates jobs and tax revenue, and some officials may be obtaining bribes or other benefits which prompts them to tolerate piracy.
- As a developing country, China (like many other developing countries) lacks the resources and a sophisticated legal system to go after and punish IPR violators, and that establishing an effective enforcement regime will take time.<sup>63</sup>
- As a practical matter, IPR enforcement in China will always be problematic until Chinese-owned companies begin to put pressure on the government to protect their own brands and other IPR-related products.
- Chinese trade barriers and regulatory restrictions on IPR-related products and their distribution are so onerous that they prevent legitimate products from entering the market, or raise costs so high that they are unaffordable to the average individual, thus creating a huge demand for low-cost pirated products.

## **The U.S. WTO Cases Against China on IPR**

U.S. trade officials were reportedly on the verge of filing a WTO dispute resolution case against China in the fall of 2006 over its inadequate IPR enforcement, but were convinced by the Chinese government to give them more time to implement new IPR enforcement policies. In addition, U.S. officials indicated that they were in the process of building a WTO case on IPR that would also include Chinese trade barriers to IPR-related products (which is seen as a major factor in the high piracy rates in China).<sup>64</sup> Despite various efforts on the part of the Chinese government to improve IPR enforcement, the USTR decided to file two WTO cases against China on April 10, 2007.<sup>65</sup>

The U.S. WTO cases on China's IPR regime represent the most comprehensive and complex cases the United States has filed against any WTO to date. Most WTO cases involve specific restrictions on specific products; however these two cases challenge a broad range of China's IPR policies, and could potentially lead the WTO to authorize the United States to impose a

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<sup>61</sup> Some Chinese officials have noted that some individuals who were arrested for IPR piracy violations expressed shock at their arrest because in their minds they were not harming anybody.

<sup>62</sup> On the other hand, IPR piracy may prevent foreign firms from investing in high-tech production in China.

<sup>63</sup> Some critics of this argument note that China seems to be very efficient at going after political dissenters and others deemed to be "threats" to social stability.

<sup>64</sup> *Inside U.S. Trade*, February 21, 2007.

<sup>65</sup> For example, the Chinese government claimed it seized 73 million pirated products in 2006, made improvements to its legal system and increased prosecutions, and that it developed a national comprehensive strategy to deal with piracy.

significant level of sanctions against China.<sup>66</sup> Specifically, the U.S. WTO complaints against China's IPR regime involve the following issues:<sup>67</sup>

- The thresholds for criminal prosecutions of IPR violations are too high, meaning the government will only pursue cases it considers to be serious or excessively large, creating a safe harbor for smaller producers or violators. In addition, the thresholds for prosecuting IPR violations are based on the value of the pirated products rather than the value such legitimate products would fetch in the marketplace. Such thresholds make it very difficult to pursue cases against many commercial producers of illegal IPR-related products.
- China often allows seized imported pirated goods to re-enter the market rather than disposing of them.
- China's copyright laws fail to protect imported works (such as movies) that are under review by Chinese censorship authorities (and must be approved before the works can be distributed in China). As a result, pirated copies of the works can be widely distributed without violating copyright law and thus do not face prosecution.
- Chinese IPR laws do not appear to allow producers of pirated products to be prosecuted unless they also illegally distribute such products.
- China has not abided by its 2001 WTO accession agreement to liberalize its rules on trading rights and distribution services. As a result, U.S. IPR-related products face significant trade barriers in China, and such barriers are a major factor for causing the high rate of piracy in China.

On January 26, 2008, the a WTO panel ruled on the first IPR cases dealing with enforcement issues, finding that several aspects of China's IPR laws and enforcement policies raised by the United States were inconsistent with WTO's TRIPS Agreement. However, the panel determined that it needed more evidence on the issue of thresholds for criminal prosecutions of IPR piracy before a determination could be made.

## Applying U.S. Countervailing Laws to China<sup>68</sup>

Many critics of Chinese trade policies contend that the Chinese government provides a significant level of subsidies to many of its industries, such as preferential bank loans and grants, debt forgiveness, and tax breaks and rebates.<sup>69</sup> In addition, some analysts charge that China's currency policy constitutes a form of government export subsidy.<sup>70</sup> Such critics contend that U.S.

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<sup>66</sup> If the cases go to a WTO dispute resolution panel, and that panel ruled in favor of the United States, the panel would seek to estimate that level of trade losses suffered by the United States due to China's failure to enforce its IPR laws or to provide market access to IPR-related products. This figure could potentially be over a billion dollars (based on U.S. industry estimates of trade losses from IPR piracy in China).

<sup>67</sup> See USTR April 9, 2007, Press Release and related documents at <http://www.ustr.gov/index.html>.

<sup>68</sup> For additional information on this issue, see CRS Report RL33550, *Trade Remedy Legislation: Applying Countervailing Action to Nonmarket Economy Countries*, by Vivian C. Jones.

<sup>69</sup> See USTR 2007 *National Trade Estimates of Foreign Trade Barriers*, April 2, 2007.

<sup>70</sup> They charge that government intervention in currency markets to keep the value of the yuan low vis-a-vis the dollar, keeps the price of Chinese exports low.

countervailing laws, which seek to address the negative impact foreign government subsidies on exported products may have on U.S. producers in the United States, should be applied to nonmarket economies such as China.<sup>71</sup>

Until very recently, the Commerce Department contended that U.S. countervailing laws could not be applied to a non-market economy because of the assumption that most production and prices in such an economy are determined by the government, and thus it would be impractical to determine the level of government subsidy that might be conveyed to various exported products. However, in November 2006, the Commerce Department decided to pursue a countervailing case against certain imported Chinese coated free sheet paper products. On March 30, 2007, the Commerce Department issued a preliminary ruling to impose countervailing duties (ranging from 11% to 20%) against the products in question. Commerce contends that, while China was still a non-market economy for the purposes of U.S. trade laws, economic reforms in China have made several sectors of the economy relatively market based, and therefore it is possible to identify the level of government subsidies given to the Chinese paper firms in question.<sup>72</sup> Thirteen countervailing cases have been brought against a number of other Chinese products since 2006.<sup>73</sup>

Many Members of Congress have called on the Administration to expand its use of countervailing measures against Chinese products. Some have proposed codifying the use of countervailing laws against non-market economies, and others have sought to make China's undervalued currency a factor in determining the level of countervailing duties.

## **China Safeguard Provisions**

As noted earlier, when China entered the WTO, it agreed to allow the United States to continue to treat it as a non-market economy for 12 years (codified in U.S. law under Sections 421-423 of the 1974 Trade Act, as amended) for the purpose of safeguards.<sup>74</sup> This provision enables the United States to impose restrictions (such as quotas and/or increased tariffs) on imported Chinese products that have increased in such quantities that they have caused, or threaten to cause, market disruption to U.S. domestic producers.<sup>75</sup> The Bush Administration on six different occasions chose not to extend relief to various industries under the China-specific safeguard (even though in four cases, the USITC recommended relief). Some Members have called for limits on the President's discretion to prevent import relief.

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<sup>71</sup> The relief comes in the form of additional duties that are imposed on the imported products in question after a determination is made that a foreign government subsidized export to the United States has harmed a U.S. producer. The additional duties are intended to offset the impact of the subsidy.

<sup>72</sup> Countervailing investigations have also been initiated of Chinese off-the-road tires (June 18, 2007) and Chinese steel pipe (June 14, 2007).

<sup>73</sup> *Inside U.S. Trade*, "China-Focused Trade Remedy Cases Expected To Increase," November 26, 2008.

<sup>74</sup> The U.S. International Trade Commission (USITC) is in charge of making market disruption determinations under the safeguard provisions for most products (with the exception of textiles and apparel, which are handled by the Committee for the Implementation of the Textile Agreements, an inter-agency committee chaired by the U.S. Commerce Department). Import relief is subject to presidential approval.

<sup>75</sup> Normally, safeguard provisions apply to all imported products. The China safeguard in U.S. trade law applies only to China.

## Textile and Apparel Products<sup>76</sup>

Various U.S. industry groups have called on the Administration to invoke special safeguard provisions (included in China's WTO accession package) that would enable the United States to restrict imports of certain Chinese products deemed harmful to U.S. industries. U.S. producers of textile and apparel products have been particularly vocal over the competitive pressures they face from China, especially since U.S. textile and apparel quotas on Chinese goods were eliminated in January 2005.<sup>77</sup> According to the U.S. Commerce Department, China is the largest foreign supplier of textiles and apparel to the United States at \$32.7 billion, or 35.1% (2008); from 2002 to 2008, U.S. textile and apparel imports from China rose by 274%.<sup>78</sup>

The sharp rise in textile and apparel imports from China, and U.S. industry contention that these imports were disrupting U.S. markets, led the Bush Administration to seek an agreement with China to limit its exports to the United States. On November 8, 2005, China agreed to restrict various textile and apparel exports to the United States (according to specified quota levels) from January 2006 through the end of 2008.

## The U.S.-China Strategic Economic Dialogue (SED)

On September 29, 2006, President George Bush and Chinese President Hu Jintao agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the "highest official level." According to a U.S. Treasury Department press release, the intent of the SED was to "discuss long-term strategic challenges, rather than seeking immediate solutions to the issues of the day," in order to provide a stronger foundation for pursuing concrete results through existing bilateral economic dialogues.<sup>79</sup> The first meeting (chaired by Secretary of Treasury Paulson and Chinese Vice Premier Wu Yi) was held in December 2006. Four subsequent rounds of talks were held (the last was in December 2008).

During the Bush Administration, the two sides largely focused on four main topics: macroeconomic policy (including China's currency policy), innovation and IPR protection, energy and the environment, and services trade and investment. The United States sought to induce China to: quicken the pace of its currency reforms, expand market access for financial and non-financial services (beyond its WTO accession commitments), take steps to boost domestic consumption (including developing a social safety net), improve the business climate in China for U.S. firms (such as through greater transparency of rules and regulations), and to address U.S. high priority trade issues (such as Chinese restrictions on U.S. beef, IPR protection, and health and safety issues regarding Chinese products).<sup>80</sup>

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<sup>76</sup> For additional information, see CRS Report RL34106, *U.S. Clothing and Textile Trade with China and the World: Trends Since the End of Quotas*, by Michael F. Martin.

<sup>77</sup> For additional information on U.S.-China textile issues, see CRS Report RL32168, *Safeguards on Textile and Apparel Imports from China*, by Vivian C. Jones.

<sup>78</sup> For more detailed data on U.S. imports of textile and apparel products from China, see Department of Commerce, Office of Textiles and Apparel Office website at <http://www.otexa.ita.doc.gov/>.

<sup>79</sup> U.S. Treasury Department press release, December 15, 2006.

<sup>80</sup> For a listing of major agreements and achievements of the SED, see the U.S. Department of Treasury's website at <http://www.ustreas.gov/initiatives/us-china>.

Many Members of Congress praised the SED as an effective process to deal with major long-term bilateral economic issues, while others criticized it for failing to yield many concrete results. The Obama Administration has indicated that it plans to continue the SED process on a two track basis: the first to cover political, security, and global issues, and the second to cover economic issues.

## **U.S.-China Trade Legislation in the 111<sup>th</sup> Congress**

Several bills have been introduced in the 111<sup>th</sup> Congress to address various concerns over China's economic policies:

- H.Res. 44 would condemn China for its “socially unacceptable business practices, including the manufacturing and exportation of unsafe products, casual disregard for the environment, and exploitative employment practices.”
- H.R. 471 would limit the President's discretion to deny relief under the special China safeguard provision.
- H.R. 496 would ensure that the Commerce Department continued to apply U.S. countervailing laws to non-market countries (such as China), establish an alternative method for determining countervailing duties on Chinese products, and would limit the President's discretion to deny relief under the special China safeguard provision.
- H.R. 499 would codify the application of U.S. countervailing laws to non-market economies, establish an alternative method for determining countervailing duties on Chinese products, and would require congressional approval before China (and other non-market economies) could be treated as a market economy.
- H.R. 1105 (P.L. 111-8) contains a provision to continue a prohibition on the U.S. Department of Agriculture from rulemaking that would allow imports of cooked chicken from China.
- S.Res. 76 would express the sense of the Senate that the United States and China should work together to reduce or eliminate tariff and nontariff barriers to trade in clean energy and environmental goods and services.
- S.Res. 77 would express the sense of the Senate that the United States and China should negotiate a bilateral agreement on clean energy cooperation.
- S.Res. 91 would call on the Consumer Product Safety Commission, the Secretary of the Treasury, and the Secretary of Housing and Urban Development to take action on Potential safety issues relating to drywall imported from China.
- S. 739 would require the Consumer Product Safety Commission to study drywall imported from China in 2004 through 2007 in regards to potential safety hazards and to ban future drywall imports from China.

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